Ethical investing and performance: the price of conscience

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Biography

Quintin has worked for actuarial and investment consultancy firms and a multi-national European bank, including wide experience in quantitative fund and risk analysis. He is a Fellow of the Institute of Physics, a Chartered Fellow of the CISI and a Chartered Wealth Manager. Quintin has applied skills gained from his Oxford University Physics Doctorate and while working in engineering to finance. He is the second UK graduate from the Sustainable Investment Professional Certification (SIPC) programme and joined P1 Investment Management in January 2017, founding their ethical and sustainable investing proposition.

Introduction

Previous articles asked why ethical investment matters [1], introduced sustainable (environmental, social and governance, or ESG) investing [2]; or looked at different approaches [3], [4], including fund selection [5]. This article is the first of two considering the 'price of conscience', challenging the view that ethical investments are more likely to underperform. Here, arguments supporting ethical out-performance are explored, while a future article will review studies of actual performance.

How might ethical investments compare with conventional counterparts? Could they tend to underperform? Particularly as 'ethical' or 'green' labels might be applied for marketing advantage.

Investors often perceive that ethical investing reduces the number of companies available for portfolios. The smaller 'opportunity set' reducing diversification possibilities, resulting in worse returns, higher risk, or both. This article proposes counter-arguments challenging this perception by exploring risks, and asking whether sustainable investing can provide a competitive advantage [6], [7].

Sustainable Investing and Risk

Proponents of sustainable investing argue that unethical corporate behaviours increase risk [8], [7]. Companies' harmful actions eventually lead to negative consequences for them, with detrimental effects on growth and profits, leading to underperformance. Essentially running risks that are not 'priced in' by markets. Investors excluding these companies remove unrewarded risk from their portfolios.

Such practices can increase the likelihood of litigation against the company, cause reputational damage, or make customers take business elsewhere. Other risks may include:

- Weak industry standards could stimulate government regulation, increasing business costs to all companies in that sector [9]. Firms with the least invested in meeting standards will be forced to improve and be harder hit.
- Environmental issues, such as CO_2 emissions restraints or carbon permit trading. Companies adopting the appropriate technologies may avoid redesign costs. At the same time, those continuing harmful practices may require investment or to accept higher ongoing business costs.

- Ethical behaviour gives a company a 'licence to operate', as a valued community asset, avoiding resentment about activities [7]. Community opposition can upset projects and damage brands. Oil-spills can cause reputational damage lasting decades.
- Poor sustainability records can raise insurance premiums or increase the cost of capital. Investor concerns can lower share prices and increase the cost of debt through weaker bond issuance.
- Unethical supply-chain partners can tarnish brand reputation.
- Energy usage reduction and waste minimisation increases efficiency and reduces costs.

Other business risks relate to emissions and waste discharges (particularly affecting companies in mining, oil, gas and forestry sectors); balance sheet risks from historical liabilities; and business sustainability risk. Companies may face the intrinsic lack of sustainability of their activities. Examples include coal mining, especially high-sulphur coal producers.

Competitive Advantage

Ethical companies can build a good reputation, bringing financial rewards. Businesses can earn legitimate profits, contributing to society, avoiding coercive, exploitative or illegal practices. Internationally, some countries have lesser standards for human rights, labour, bribery and the environment [10].

Trustworthy reputations attract customers and business partners, creating economic opportunities [11]. Not everything immoral is illegal: staying within the letter of the law is insufficient to protect reputation. An organisation's ethical culture helps protect it from unlawful staff conduct since strong moral principles help limit abuses by staff tempted to circumvent regulation. Further, companies with stronger ethical reputations should command higher PE ratios for their stock and be able to borrow at lower rates in bond markets.

A 2010 study [12] concluded that positive CSR strategies, although initially perceived by analysts as being value-destroying, are now seen as value-creating. Analysts are now more likely to recommend a stock 'buy' for strong CSR firms.

Other sources of competitive advantage include [7]:

- Attracting, retaining and motivating top talent.
- Anticipating changes in regulatory and business environments ahead of competitors.
- Generating revenue growth through new products, services and technologies.
- Increasing customer and investor loyalty.
- Improving relations with regulators, local suppliers, communities and key stakeholders.
- Strengthening innovation and adaption within the corporate culture.

How this helps Investors

Individuals increasingly wish to invest ethically and often have specific concerns in mind. Younger people may give this a higher priority than older generations with twice as many 18 to 34-year-olds feeling their pensions should be invested ethically, compared with those above 45 [13]. The Investment Association reports £27.9 billion of assets in the UK responsible funds sector in January 2020, an increase of £3.2 billion since October 2019 [14].

Individuals will wish to be confident that ethical investing is unlikely to be detrimental to portfolio performance. However, the selection of suitable ethical funds is a complex area. So some investors are likely to wish to access the skills of wealth managers who can support them in this important and growing field.

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Policy news

Congratulations are due to Peter Parry on being invited to join the **Advisory Panel for the Law Commission Review of Intermediated Securities**.

Readers may recall that UKSA and ShareSoc submitted a joint response last November to the Law Commission's call for evidence on intermediated securities, primarily those held by an intermediary or nominee on behalf of the beneficial shareholder. The full response can be found here.